New England Electric System

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The Honorable John D. Dingell
U. S. House of Representatives
Committee on Commerce
Room 2125, Rayburn House Office Building
Washington, DC 20515

Dear Congressman Dingell:

Thank you for you letter of April 10, 1997, in which you elicited our views on a variety of issues relating to the restructuring of the electric utility industry.

As you may know, restructuring has been a very hot topic here in New England, and the companies of the New England Electric System have played a very active and constructive role in the debate. In Rhode Island we have worked closely with the legislative leadership to pass first-in-the nation comprehensive restructuring legislation that will bring choice to all Rhode Island customers by July 1, 1998. In Massachusetts, we have reached a comprehensive restructuring settlement with a wide variety of stakeholders, include industrial, commercial and residential consumers, and independent power and environmental interests. Under the terms of that settlement, which has now been approved by the Massachusetts Department of Public Utilities, all of our Massachusetts customers will be afforded a choice of generation suppliers, and even a guaranteed 10% rate reduction for those who do not immediately enter the market, effective January 1, 1998. In New Hampshire, we have reached a similar settlement with consumer interests that is presently under consideration by the New Hampshire PUC.

We believe that our experiences in each of these jurisdictions have given us a unique perspective on restructuring, one born of experience. We are pleased to offer that perspective in response to your questions.

1. From your company's point of view, is it necessary for Congress to enact legislation bearing on retail competition, and why? If you favor legislation, please outline which issues should be addressed and how you think they should be resolved.

Answer Federal legislation will be necessary at some point to complement and facilitate state initiatives for retail competition. Among the issues best addressed at the federal level are:

- PUHCA repeal and PURPA reform.
- Jurisdiction. State and federal jurisdiction over transmission facilities serving newly competitive retail markets must be clarified.
- Transmission Access. FERC Orders 888 and 889 must be legislatively extended to utilities now exempt from FERC regulation.
- Reciprocity. Utilities in states that have not adopted retail competition must open their retail markets as a precondition to entering into the retail markets of states that have adopted retail access.
- Competitive Parity. Public and private utilities must be placed on an even playing field to assure efficient regional and national retail electric markets.

2. If the state(s) you serve has adopted or is considering adopting retail competition, what are your biggest concerns? Please be specific. Indicate how you are dealing with them and any recommendations you may have.

Answer All three of the states now served by the NEES companies have adopted retail competition. In New Hampshire and Massachusetts, retail access is scheduled to commence January 1, 1998. In Rhode Island, retail access will commence as early as July 1, 1997 for certain customers, and extend to all customers by July 1, 1998. To meet these very aggressive schedules, the NEES companies, in exchange for assured stranded cost recovery, have agreed to voluntarily amend their historic, inter-affiliate all requirements FERC tariff to allow for early termination, and to voluntarily divest their generation portfolio. The NEES companies have now taken substantial steps to implement those undertakings. Our biggest concern is that federal legislation, if overly broad or poorly drawn, will undo or substantially impair these agreements, thereby irreparably harming the NEES companies. While the NEES companies have been and continue to be strong proponents of industry restructuring and retail access, their very survival depends upon federal respect for the agreements that have been entered into to implement state-sponsored restructuring initiatives.

3. Whether or not you favor federal legislation, please indicate your position on the following specific issues (to the extent not addressed in your responses):

a. *A Federal mandate requiring states to adopt retail competition by a date certain.* If retail competition is under consideration in the state(s) you serve, do you believe Congress should provide additional direction or authority?

Answer With the possible exception of the need for jurisdictional certainty referenced above, Congress need not provide additional direction or authority to effectuate retail access in any of the states served by the NEES companies. Congress nonetheless may decide that a federal mandate requiring retail competition by a date certain is the most effective way to assure competitive parity and reciprocity. The NEES companies will support a well-crafted federal bill that mandates access by a date certain if it respects previously enacted or adopted state initiatives for retail access.

b. *Recovery of stranded investment.* If the state(s) you serve already has adopted retail competition, how was this issue addressed and are you satisfied with the outcome? If your state(s) is considering adopting retail competition, how would you recommend that this issue be treated? Do you think Congress should enact legislation relating to stranded cost issues, and if so what would you recommend? Is securitization a useful mechanism for dealing with stranded costs, and whom does it benefit?

Answer In consideration of the NEES companies' agreement to voluntarily amend their inter-affiliate all requirements contract to allow for early termination, and to voluntarily divest their generation assets, legislative authorities in Rhode Island and regulatory authorities in Massachusetts have agreed to stranded cost recovery on terms and conditions acceptable to the NEES companies. An interim settlement embodying similar terms and conditions is now pending before the New Hampshire PUC. As noted above, Congress need not provide additional legislative direction or authority, particularly with respect to the issue of stranded cost recovery, to effectuate retail access in any of the states served by the NEES companies.

Should Congress nonetheless enact legislation relating to stranded costs issues, it must respect the stranded cost determinations of these previously enacted state restructuring initiatives. The NEES companies would be severely prejudiced if Congress were to restructure that which had already been restructured in Rhode Island or Massachusetts.

More fundamentally, such legislation must recognize, as have the vast majority of states adopting retail competition, and as did FERC in its historic Order 888, the compelling equitable and legal arguments that favor full stranded cost recovery. Stranded costs arise from a fundamental shift in public policy. Generation cannot be put to market without "open access" to transmission and distribution wires. Absent legislation or a regulatory order compelling utilities to open their transmission and distribution systems to competitors, stranded costs simply would not arise. It is the taking of a utility's wires, and not technology or market forces, that

"strands" other utility investments, the costs of which are already in rates. As a matter of equity, utility shareholders must not bear the financial burden of this dramatic shift in public policy. As a matter of law, utilities are entitled to just compensation for the taking of their wires, which would include not only the value of the wires themselves, but all other assets made less valuable by reason of the taking.

Securitization does not affect the calculation of these stranded investments. If done properly, however, securitization can reduce the collection costs of stranded investment, and these savings can be passed on to customers. In order for securitization to work fairly and produce real customer savings, legislation must be carefully crafted to cover bankruptcy, tax and credit issues. Additional savings could be obtained if securitization were exempt from federal income taxes.

c. *Reciprocity.* Can states condition access to their retail markets on the adoption of retail competition by other states? Should Congress enact such a requirement? Could such a requirement create an incentive for states with low electric rates not to adopt retail competition, in order to keep cheap power at home?

Answer Although states arguably have legal authority to condition access to their retail markets on the reciprocal adoption of retail competition in other states, the better approach would be for Congress to enact a reciprocity provision pursuant to its undisputed Commerce Clause powers.

4. If Congress enacts comprehensive restructuring legislation, should it mandate "unbundling" of local distribution company services? What impact would this have, and would the effects differ for various customer classes? Would this entail substantial expense, and who would incur any such costs?

Answer Congress should not mandate the so-called "unbundling" of local distribution company services, particularly billing and metering services. Even if Congress were to enact comprehensive restructuring legislation, local distribution companies and the services they provide would almost certainly remain subject to traditional cost based regulation by state authorities. There is no evidence to suggest that state regulation of such services has proven ineffective, or that federal preemption is warranted.

Nor is there any evidence to suggest that the unbundling of these services would enhance economic efficiency, or advance consumer interests. To the contrary, unbundling distribution services may well delay the introduction of supplier choice and degrade customer service. Moreover, unbundling such services would result

in negligible savings. Even assuming that a competitive market could reduce the cost of these services by 10%, the savings to the average retail customer would be slightly less than 1 mill per kwh, or 40¢ on a typical bill of $54.40.

5. Recently Chair Molder of the Federal Energy Regulatory Commission recommended that, as part of comprehensive legislation, Congress authorize the Commission to enforce compliance with North American Electric Reliability Council standards to help maintain reliability of service. Do you believe this is necessary, and why or why not?

Answer The NEES companies support Chair Moler's call for industry wide reliability standards enforced by FERC.

6. What concerns does your company have with respect to the role of public power and federal power marketing agencies in an increasingly competitive wholesale electric market? In markets in which retail competition has been adopted? Are there concerns you would like to have addressed if Congress enacts comprehensive restructuring legislation? Should Congress consider changes to federal law as it applies to regulation of public or federal power's transmission obligations?

Answer The unrestricted participation of public power entities and federal power marketing agencies in competitive wholesale and retail generation markets would concern the NEES companies. Tax free financing, operating subsidies and favored tax treatment afford public power and power marketing agencies substantial cost advantages over private market participants, including particularly investor owned utilities. Even though the NEES companies have agreed to divest their generation, their unregulated marketing affiliate would still be disadvantaged in competition with subsidized market participants.

Similarly, the NEES companies would be concerned if the open access provisions of FERC's Order 888 and 889 were not made applicable to public power's transmission facilities. Absent open access, public power could avail itself of the transmission facilities of others to reach off-system customers while effectively blocking access to its own native load. Public power could likewise restrain wholesale and retail competition by refusing to wheel a competitor's power to third party markets.

Over time, the financial and regulatory advantages presently enjoyed by public power could frustrate the development of a truly competitive wholesale and retail generation market. If emerging wholesale and retail generation markets are to be vigorous and competitive, there must be financial and regulatory parity for all market participants.

7. If Congress enacts comprehensive restructuring legislation, should changes be made to federal, state or local tax codes, and if so why? Please be specific.

Answer: If Congress enacts comprehensive restructuring legislation, tax codes will have to be amended to assure competitive parity. Utilities historically have been subject to disproportionate tax treatment, particularly at the state and local level. Gross receipts taxes and property taxes on equipment are common examples of taxes that fall most heavily upon utilities. In past, utilities have been able to pass these taxes through to ratepayers in the form of cost of service utility rates. In effect, utility rates have masked taxes actually levied upon ratepayers. In a competitive generation market, however, utilities would be severely disadvantaged by this disproportionate tax treatment. In the future, similarly situated companies must be taxed on comparable terms.

8. What, if any, concerns do you have about the reliability of the electric system? If the industry moved to retail competition, will adequate reserves be available? Is the transmission system capable of handling full retail competition?

Answer: With appropriate enforcement of industry wide reliability standards, the NEES companies do not believe that restructuring will affect overall system reliability.

With respect to generation, deregulated generation markets will provide effective "price" signals to assure that adequate reserves are available.

With respect to transmission, power flows immediately after the introduction of retail competition will be virtually the same as before competition. Over time, new load and generation will modify these flows, and reliability will depend upon the proper pricing of transmission services.

Distribution reliability should be largely unaffected by the advent of a competitive retail market. Distribution will remain subject to cost-based regulation at the state level.

9. If Congress enacts legislation on retail competition, should changes to the Public Utility Company Holding Act of 1935 (PUHCA) be included? If so, what would you recommend? In particular, how should Congress address market power concerns in any such legislation? Are transition rules needed during the period before effective competition becomes a reality?

Answer: PUHCA should be repealed. Although many contend that PUHCA repeal should await the enactment of comprehensive restructuring legislation by Congress, in

point of fact comprehensive restructuring has now been adopted in many states, and in all of the states that NEES serves. Retail competition is already a reality. The repeal of PUHCA will ensure the success of these state-sponsored restructuring initiatives, and greatly invigorate retail competition. Absent repeal, continuing uncertainty about the fate of PUHCA will restrain many competitors from entering into these newly opened markets. Absent repeal, NEES and other registered holding companies who are already market participants will be disadvantaged by duplicative regulatory controls that do not apply to new entrants or non-registered utilities.

Congress need not address market power concerns in PUHCA repeal legislation. PUHCA has not been used by the SEC as a means of guarding against market power. The integrity of the market will continue to be protected by the Department of Justice under the federal antitrust laws, and through FERC and State regulation concerning terms and conditions of service.

More fundamentally, however, the integrity of the market will be assured by state-sponsored restructuring itself. By unbundling retail power sales from local distribution services, such legislation opens up a huge market to competition by and between power suppliers for any and all retail customers. In effect, state restructuring initiatives have broken the long standing tie between distribution service, a continuing monopoly, and retail sales, a competitive service.

10. To what degree, if any, have recent Securities and Exchange Commission administrative orders and Rule 58 decreased the need for legislative changes to PUHCA? Assuming these actions withstand any court challenges, what are your major remaining concerns about the Act?

Answer The NEES companies support recent SEC administrative decisions and rulemakings that reduce regulatory burdens under PUHCA. Any effort to streamline the present PUHCA regulatory regime benefits both consumers and shareholders. We believe that Rule 58 is such an effort. The SEC staff has made it clear that Rule 58 should not be broadly construed as deregulation, but rather as an effort to allow holding company systems to take advantage of past SEC precedent in specifically enumerated areas.

As the SEC has itself realized, however, it does not have the authority to rescind PUHCA. It may make the administration of the Act more efficient by reducing the number of transactions that require prior approval, but it cannot rescind the significant operational and financial limitations that are imposed exclusively upon registered companies, such as the integrated system requirement, or the

requirement that holding company investments be limited to entities "reasonably incidental" to a utility system.

Moreover, absent repeal the SEC's recent attempts at streamlining the Act can themselves be rescinded or reinterpreted. Registered companies will continue to have to deal with regulatory uncertainty and exposure, and the prospect of having to divest otherwise reasonable investments should the SEC change course, unless PUHCA is repealed.

11. As electricity markets have become more competitive, some have asserted that PUHCA prevents consumers from receiving the full benefit of competition. Do you agree or disagree, and why? Is competition in wholesale or retail electric markets dependent upon the participation of the registered holding companies? Is it a certainty that changes to PUHCA would enhance actual competition? Please provide specific examples to illustrate your answers.

Answer The NEES companies agree that PUHCA may actually prevent consumers from receiving the full benefit of competition, in that PUHCA handicaps and in some cases actually excludes market entry by an entire class of competitors.

Ironically, PUHCA is itself a substantial barrier to entry in newly competitive retail markets. PUHCA not only substantially increases the costs of registered companies who are already market participants; it also restricts entry by new competitors concerned about the costly regulatory burden imposed by PUHCA. While competition in wholesale and retail markets is not, strictly speaking, dependent upon the participation of these companies, there is no evidence to suggest, and no reason to suppose that economic efficiency will be served, or consumers benefitted, by excluding companies who otherwise could constitute experienced and efficient competitors.

12. Do registered holding companies face unique problems if some states they serve adopt retail competition and some do not?

Answer PUHCA repeal would effectively alleviate the unique problems that a registered holding company might otherwise face if some of the states it serves adopt retail competition, while others do not. Absent any requirement that a holding company system operate as a single, integrated system, a multi-state company could tailor its operations to accommodate the varying policy preferences of individual states.

PUHCA repeal is thus entirely consistent with restructuring on a state by state basis. As noted above, federal legislation should facilitate, rather than frustrate or supplant, individual state restructuring preferences. PUHCA repeal is an important element of that federal legislation.

13. How do the various retail competition proposals presently pending before the Congress affect decisions regarding stranded costs for registered holding companies? Do you support any of the formulations in these bills? Do you have alternate recommendations on this or other issues unique to registered holding companies if Congress enacts retail competition legislation?

Answer Stranded cost recovery is not a problem unique to registered holding companies. Should Congress enact legislation relating to stranded cost issues, it must first respect the determinations of those states who already have enacted or adopted comprehensive restructuring plans. Congress should follow the lead of the majority of these states, as well as FERC in its Order 888, by affording utilities a reasonable opportunity to recoup all legitimate and verifiable wholesale and retail stranded costs over a time period and in a manner that does not affect financial integrity. The divestiture of generating assets need not be a precondition to stranded cost recovery. While some come close, as presently formulated none of the bills presently pending before Congress contain stranded cost formulations consistent with these principles.

We hope that you find the foregoing responses useful as you consider electric utility restructuring from the federal perspective. If you or your staff have further questions, or if you would like to discuss these matters further, please do not hesitate to contact my representative in Washington, Ralph Loomis at (202) 783-7959.

Very truly yours,

John W. Rowe